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Hugh Grant
University of Winnipeg

and

James Townsend
University of Winnipeg

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For additional information contact:

PCERII Working Paper Series
Attention: Ms. Lenise Levesque, Editorial Assistant
1-17 Humanities Centre, University of Alberta
Edmonton, AB T6G 2E5 Canada
Tel: (780) 492-0635 Fax: (780) 492-259
Email: lenise@ualberta.ca
Web Site: http://pcerii.metropolis.net

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Free Trade, Foreign Investment and Migration: Canada's Experience under NAFTA

Hugh M. Grant
University of Winnipeg and
Prairie Research Centre of Excellence on Immigration and Integration

James Townsend
University of Winnipeg

The North American Free Trade Agreement (NAFTA) is a wide-ranging economic accord between Canada, Mexico and the United States governing the flow of trade in final goods and services, investment and, of tertiary importance, labour. In the latter respect, the NAFTA stands in sharp contrast to the European Union where easing restrictions on the international movement of labour is of central importance. This paper first offers a historical perspective on Canada-US migration and then considers the institutional changes under the NAFTA. Evidence from the Canadian-US experience under NAFTA is investigated in order to consider the degree of temporary and permanent migration of labour in relation to the flow of investment and commodities. It concludes by considering whether the existing restrictions on labour flows constitute a significant constraint on economic integration or if, in contrast, they provide an important safeguard for national economic welfare.

Introduction

The North American Free Trade Agreement (NAFTA) is a wide-ranging economic accord between Canada, Mexico and the United States governing the flow of trade and investment. Of secondary importance is the international movement of labour. In contrast to the European Union, where easing restrictions on the labour mobility across borders is a central component, parties to the NAFTA make few concessions to existing immigration policies. Indeed, the signatories to the Agreement state explicitly the need to "protect the domestic labour force and permanent employment in their respective territories" (NAFTA, Article 1601).

Keywords: Trade; Migration; Canada; United States.

The only significant provisions with respect to labour involve facilitating the temporary entry of business people and skilled workers. Making only a modest accommodation to a freer flow of labour is not surprising: the significant wage disparity between Mexico on the one hand, and Canada and the United States on the other, makes an open borders policy politically, if not economically, untenable (Garson, 1998). Less clear, however, are the implications of a greater movement of trade and investment for the demand for complementary labour flows. Is there any compelling evidence to suggest that the removal of barriers on trade and investment has placed increasing pressure on existing arrangements governing migration?

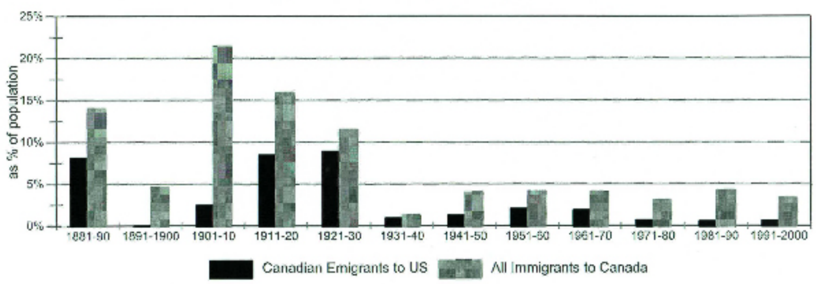
This paper first offers a historical perspective on Canada-US migration and then considers the relationship between trade, foreign investment and migration under the NAFTA. Canada has experienced a dramatic increase in the value of trade and foreign investment flows in the past dozen years; however, the movement of temporary workers has been extremely one-sided with very little inflow from the US (see Figure 1). The small number of temporary migrants to Canada is attributed to the nature of the multinational firms and their propensity to locate skill-intensive functions in the home country, while the increasing outflow from Canada likely reflects the accumulated demand for permanent migration finding an alternative outlet for entry to the US [See Figure 1]. The asymmetry suggests that existing restrictions on labour flows have not constituted a significant constraint on trade and capital flows.

Canada-US Migration in Historical Perspective

Canada occupies a rather unique position in terms of international migration. While it has traditionally been the second largest recipient country in the world (in recent years admitting as many as 250,000 people a year), it has experienced a significant outflow of population to the United States during periods of high international mobility. Figure 2 displays the inflow of immigrants to Canada and the outflow of Canadians to the United States. During the wave of international migration between 1911 and 1930, Canada absorbed over 2.7 million immigrants. At the same time, however, over 1.6 million Canadians departed for the United States, a striking figure given the total population of the country was on the order of 10 million. The post-World War II period also witnessed a significant number of Canadians moving to the US, with roughly a

Figure 1: Canadian Migration

Emigration to US and Total Immigration

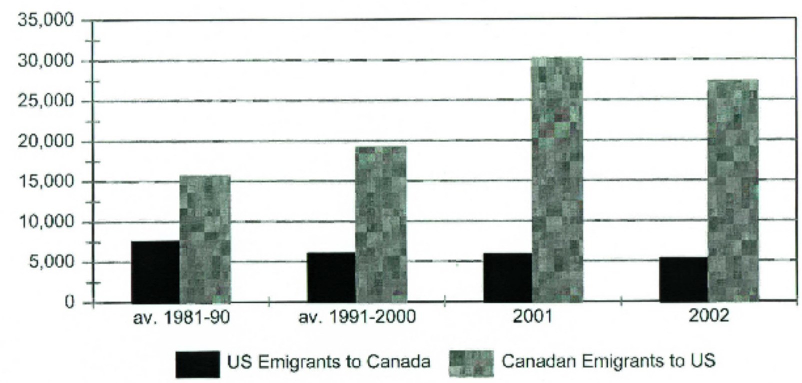


million emigrating between 1945 and 1970. In total, roughly one-sixth of all immigrants admitted to the United States in the 25 years after the WWII were Canadians.

Because of this population turnover, Canada has at times been dubbed a "parking lot" country: on an inter-generational basis, relatively low-skilled migrants enter Canada, they, their children or their grandchildren accumulate human capital, and then move to the United States in pursuit of higher wages. This metaphor is related to another circulating in the 1960s which viewed Canada as a "vertical mosaic" with a hierarchy of ethnic groups sorted by income and skill level, the newest cohort of migrants at the bottom, older cohorts stacked on the top, and the oldest poised to depart for the United States (Porter, 1965).

The "displacement thesis", developed to address the simultaneous inflow and outflow of migrants, argues that the high rate of emigration is encouraged by the relationship between immigration and trade policy. According to Dales (1964), Canada's historic status as a high-tariff, high-immigration country has resulted in real wages being lower in Canada than the United States. Import duties increase the demand for labour in the protected sector while increasing the price level; however, high immigration flows keep the nominal wage fixed, such that the real wage falls relative to that in the United States. This results in the simultaneous inflow of immigrants from the rest of the world to Canada and the emigration of more highly mobile Canadians to the US (see Appendix I).

Figure 2: Permanent Migrants
Canada-US, 1981-2002



The world, of course, has changed significantly since the displacement thesis was first put forward. Over the last three decades of the century, Canada continued to receive over 200,000 immigrants a year, but the average annual outflow to the United States fell to less than 20,000. Despite a marked up-turn in the past two years, fewer than 30,000 Canadians emigrated there in 2002. This downward trend parallels the decline in migrants from Western Europe to the United States.

It is difficult to attribute the decline in Canadian emigration to economic factors. The financial incentive to move can be viewed in terms of the difference in expected income and the likelihood of finding employment. Despite the rapid inflow of US foreign direct investment in Canada and a modest decline in Canada's tariff structure following the Kennedy Round of GATT negotiations in 1960, there is no obvious catch up in Canada's labour market performance. Although the gap in GDP per capita between Canada and US fell sharply during the 1970s, it increased just as acutely during the 1980s and 1990s (see Figure 3a). Moreover, the unemployment rate in Canada diverged from the US rate after 1980 such that a gap of about 3-4 percent emerged (see Figure 3b). If anything, then, economic incentives to migrate to the US increased after 1980.

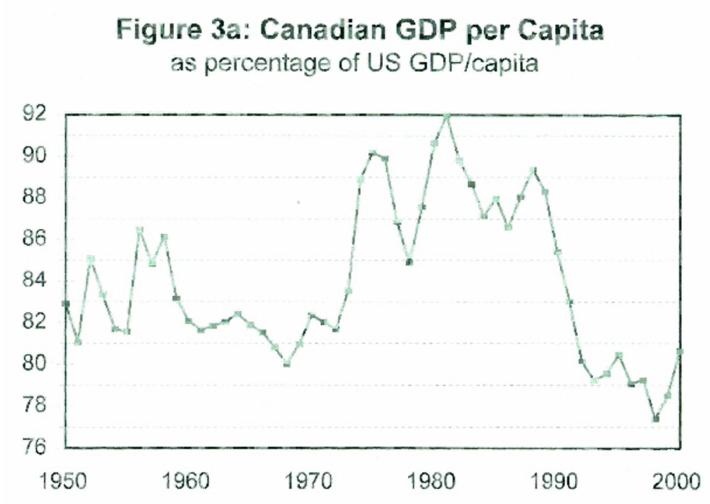


Figure 3a: Canadian GDP per Capita
as percentage of US GDP/capita
92
90
88
86
84
82
80
78
76
1950
1960
1970
1980
1990
2000

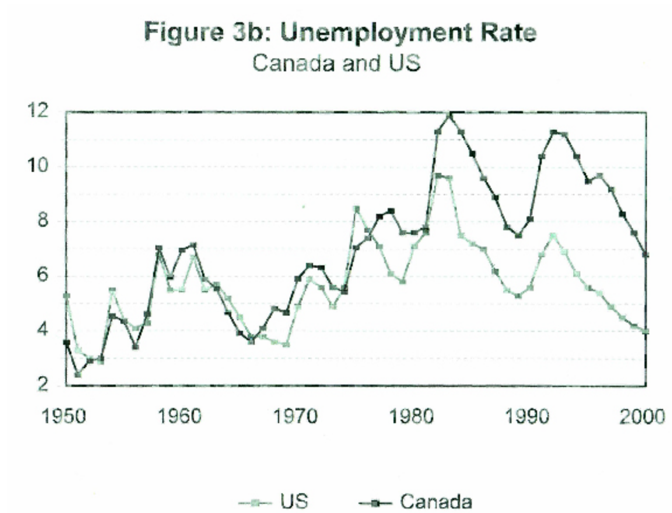


Figure 3b: Unemployment Rate
Canada and US
12
10
8
6
4
2
1950
1960
1970
1980
1990
2000
US
Canada

In the absence of other compelling arguments, it is likely that changes in US immigration laws explain the decline in the rate of Canadian emigration: With less emphasis on country of origin and ethnicity in the selection of migrants, it became more difficult for Canadians to gain entry. In other words, the economic incentives to move did not decline, but more restrictive entry criteria were a binding constraint, resulting in a significant "pent up" demand for migration to the US.

Trade, Foreign Investment and Migration: the Canadian Experience under NAFTA

In 1987, Canada accelerated the movement toward trade liberalization when it entered into a bilateral trade agreement with the United States. Implementation of the Canada-US Free Trade Agreement (FTA) two years later resulted in the gradual elimination of tariff and non-tariff barriers to trade in a wide range of goods. The North American Free Trade Agreement (NAFTA), signed in 1994, superseded the FTA and extended coverage to Mexico. Negotiations are presently underway to strike a broader Free Trade Area of the Americas (FTAA) that would include 34 countries in the Western Hemisphere.

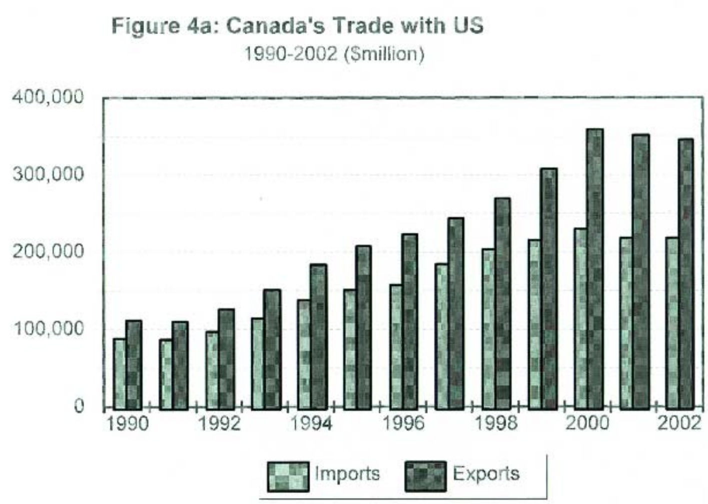
In retrospect, the FTA and the NAFTA merely anticipated changes occurring on a multilateral basis. In 1995, successful conclusion of the Uruguay Round of negotiations of the General Agreement on Tariffs and Trade (the GATT) led to the Marrakesh Agreement and establishment of the World Trade Organization (WTO). Canada's participation in the WTO involves it in a far-reaching multilateral trade agreement among 125 original participating countries covering most merchandise goods and some services. Where the FTA committed Canada to the gradual elimination of duties on most trade with the US, the WTO Agreement effectively extended similar (most-favoured nation) treatment to the rest of the world.

Canada's entry into trade liberalization negotiations, first the United States, subsequently with Mexico and other countries in the Americas, and then multilaterally under the WTO Agreement, was expected to generate several benefits for Canadians. Removing tariff and non-tariff barriers on the international movement of commodities would lead to lower prices on affected goods and services both directly, by eliminating the import tax of goods and services, and indirectly, by productivity improvements gained through firms achieving greater economies of scale in production. Moreover, rationalization of production in certain industries was expected to generate economy-wide benefits in the form of faster economic growth, lower unemployment rates and slower rates of inflation (Cox and Harris, 1986).

Trade Flows

The expansion in Canada's trade over the past 15 years has been nothing short of spectacular. Always a highly open economy, the value of Canada's exports and imports increased by 160 per cent between 1990 and 2000, such that exports now account for over 40 per cent of GDP. Trade with the United States, of course, accounts for most of this increase, with exports more than doubling and imports rising by 150 per cent (see Figure 4a).

Since the vast majority of Canada's trade is with the United States, it is tempting to contribute trade expansion to the FTA and the NAFTA. Concurrently, since these Agreements required the parties to harmonize import duties imposed on commodities produced in other countries, it is possible that the growth in Canada-US trade was a result of trade diversion, or of shifting imports and exports away from non-participating countries toward parties in the trade agreement. Surprisingly,



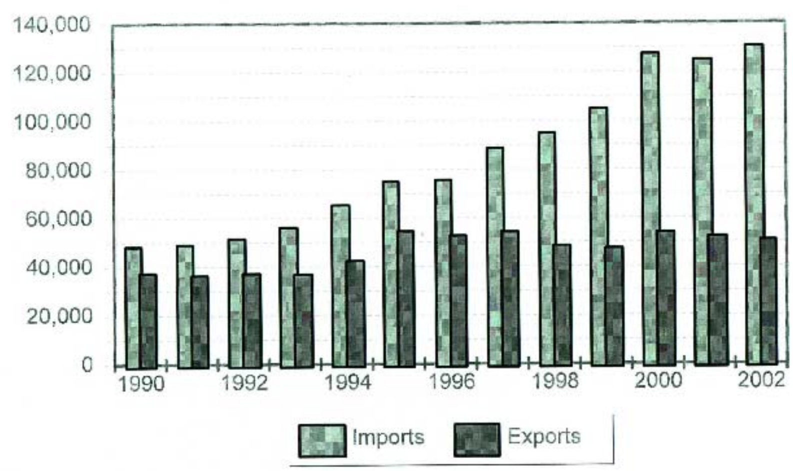
however, Canada's imports from with the rest of the world (ROW) increased at an even faster pace. The only laggard in this story is Canada's exports to the ROW, which show a comparatively modest increase of 35 percent (see Figure 4b).

Both on a bilateral basis under the FTA and the NAFTA, and a multilateral basis under the auspices of the WTO, Canada's trade has increased significantly since 1990.

Foreign Investment

The focus on trade has obscured the fact that the NAFTA is as much about removing restrictions on cross-border movements of capital as it is about trade in commodities. Both in the NAFTA (Chapters 11 and 12) and the WTO's General Agreement on Trade in Service (GATS), parties to the agreements accepted several specific obligations concerning foreign investment. In return for gaining greater access to foreign markets, countries must accept certain commitments to

Figure 4b: Canada's Trade with ROW
1990-2002 ($ million)



permit the entry of foreign firms. Specifically, the "fair treatment" article obliges each country to "accord to investors of another Party treatment no less favourable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments" (Article 11.02). Similarly, provisions covering the "national treatment and non-discrimination" prevent a country's government from favouring domestically owned firms over foreign-owned subsidiaries in its regulatory framework and its procurement of goods and services (Article 10.03).

Expansion in the stocks of foreign direct investment in Canada (FDIC) and Canadian direct investment abroad (CDIA), display a similar rate of increase to the growth in trade. FDIC has increased by 167 percent while CDIA has increased by 338 percent. Again, this increase cannot be directly attributable to North American economic integration as capital movements between Canada and the rest of the world have increased at a faster pace (see Figures 5a-d).

Figure 5a: FDI between Canada and US
Stock, 1990-2002 ($ million)

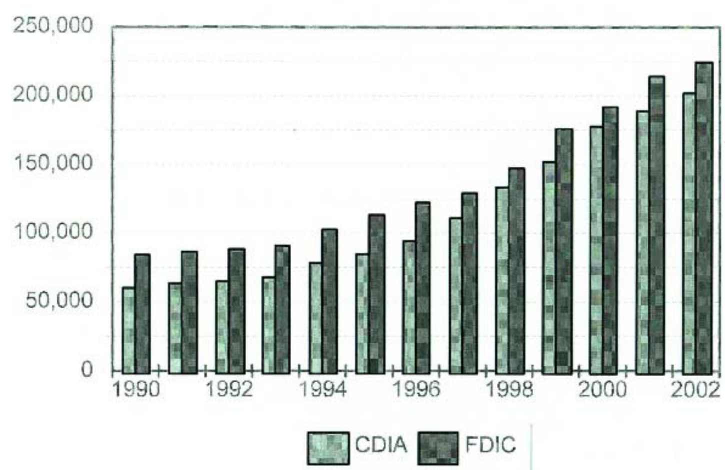


Figure 5b: FDI between Canada and ROW
Stock, 1990-2002 ($ million)

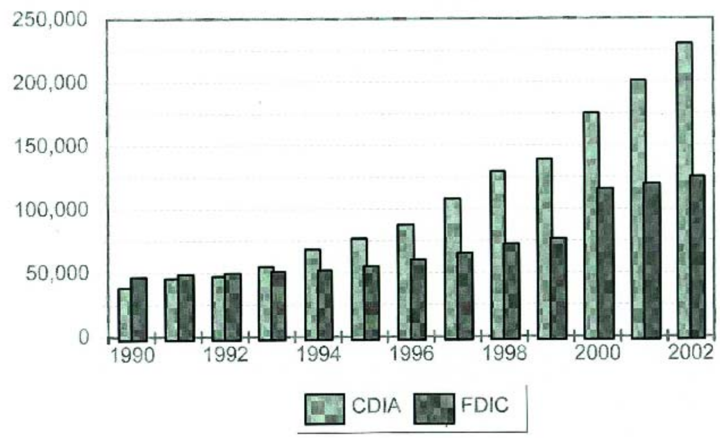


Figure 5c: Flows of FDI
Canada and the US, 1990-2001

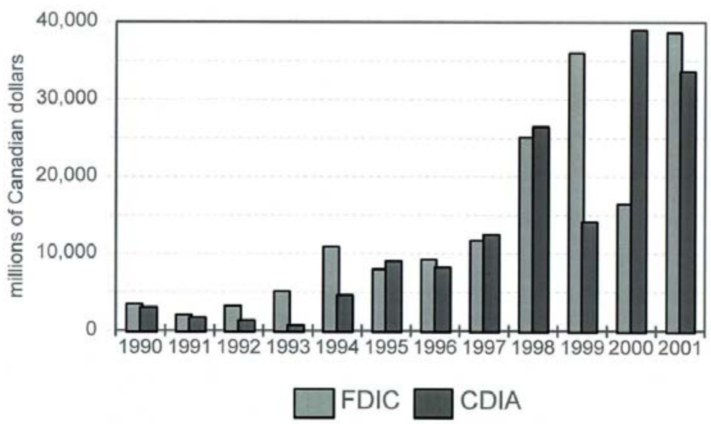
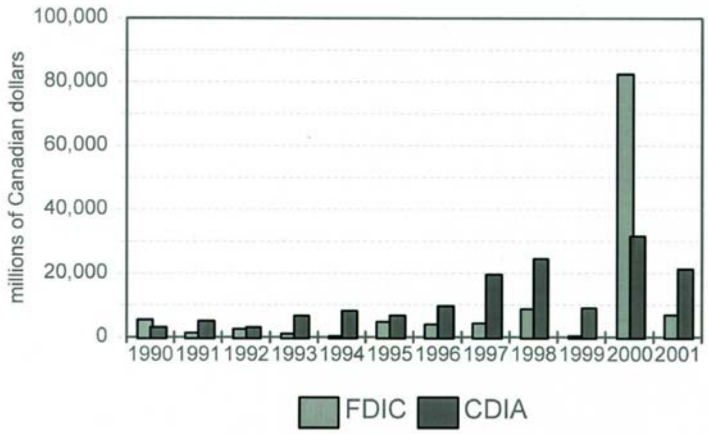


Figure 5d: Flows of FDI
Canada and the ROW, 1990-2001



One explanation for the inflow of capital from non-US sources is the content provisions under the NAFTA. In order to be subject to tariff reductions, at least 50 percent of the net cost of producing the commodity must occur in the exporting country (Article 4.01). Since this prevents a country from importing semi-finished inputs and merely assembling the final good for export, it encourages non-US firms to establish more complete production facilities in Canada in order to gain cheaper access to the US market. Canada, therefore, may serve as an export platform for non-US firms, similar to how both Ireland and Scotland have attracted foreign investment from non-European firms seeking duty free access to European markets.

The coincidence of increasing foreign direct investment and increasing trade is consistent with the findings of most research. Cameron (1998), for instance, observes that foreign-controlled firms in Canada have a higher trade intensity than their domestically-controlled counterparts: exports as a percentage of sales were twice as great and imports three times larger. Over the same period, foreign-controlled firms accounted for 43 per cent of Canada's exports and 51 per cent of imports. Moreover, two-thirds of exports to the United States were inter-affiliate transfers. It is quite likely, therefore, that the expansion in trade has been the result, and not the cause, of increased investment flows.

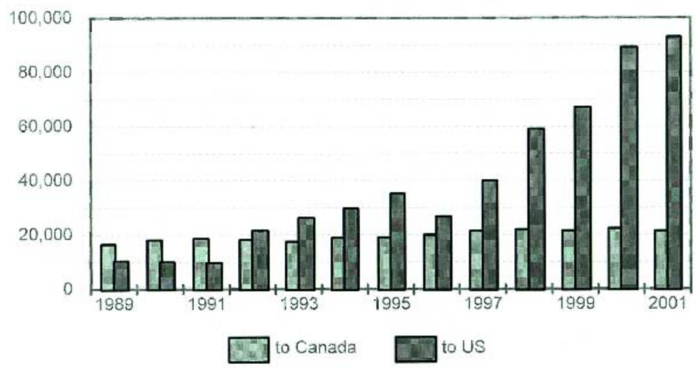
Temporary Migration

If permanent migration between Canada and the United States has largely remained at relatively low levels by historical standards, there has been an increase in the flow of temporary migrants. Article 16 of the NAFTA seeks to facilitate this flow by allowing business visitors and skilled workers to enter another country without obtaining the normal employment authorization if: a) his/her principal place of business is outside of the country and the proposed business activity in the country is primarily international in scope; b) he/she is engaged in trading activity between the two countries; c) he/she has special technical skills essential to a personal or company investment; d) he/she is a manager, executive or professional subject to intra-company transfer; or e) if he/she is "engaged in a business activity at a professional level" in one of a fairly extensive list of itemized professions.

Several caveats apply when comparing the number of temporary migrants between Canada and the United States over time. First, entries under the FTA (1989-1991) and the NAFTA (since 1991) were largely transferred from other entry categories. This has led some observers to overstate the impact of the FTA and the NAFTA on temporary migration (DeVoretz, 1999). Second, since there may be multiple entries of the same individual in a given year and the length of stay may be very brief, the number of visas issued in a given year may be greater than the number of temporary migrants at any point in time. Third, as visa requirements for business visitors to the US became more stringent, the count of temporary entrants to the US will have a tendency to increase over time (Helliwell, 1999).

These qualifications notwithstanding, there is little question that the number of Canadians entering the US as temporary migrants has increased significantly under the NAFTA: the flow of skilled workers has risen steadily to reach over 92,000 in 2001 (see Figure 6). Nor does it appear that this increase has been at the expense of entries under other categories.[1]

Figure 6: Flow of Temporary Migrants
Skilled Workers, between Canada and US



In contrast, there has been a reduction in the flow of temporary workers from the United States to Canada during the free-trade period. While the number of entries under the NAFTA has increased, these have largely substituted for previous entry categories (see Figure 7a). Perhaps more surprising is that the inflow from the rest of the world (ROW) has increased substantially (see Figure 7b).

Economic theory provides conflicting views on the relationship between migration and economic integration. In the standard Hecksher-Ohlin-Samuelson framework, trade substitutes for the movement of factors of production. Where a difference in wage rates yields a comparative advantage in labour-intensive production in the low-wage country, expansion of its exports result in an increasing demand for labour until wages are equalized in the two countries. (At the risk of oversimplification, the export of Swiss watches substitutes for the emigration of Swiss watchmakers.) This convergence in wage rates reduces the incentives to migrate.

Alternatively, if increased capital flows occur, economic integration and migration may be complementary. As a firm in one country establishes operations in another, there may be an accompanying flow of managerial

Figure 7a: Temporary Foreign Workers
Stock in Canada, 1980-2001

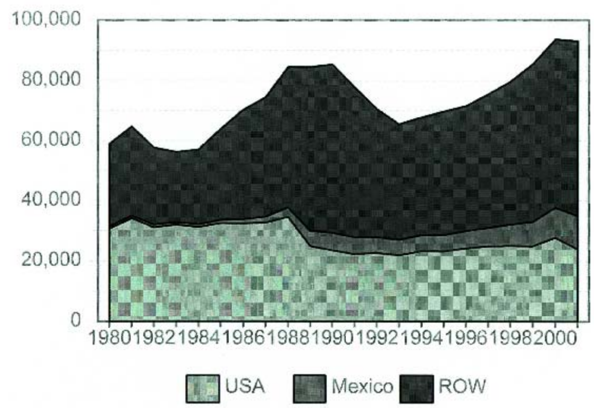
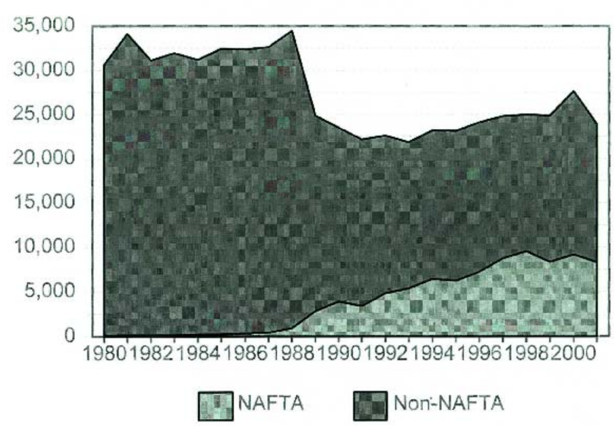


Figure 7b: Inflow of Temporary Workers
US to Canada, NAFTA and non-NAFTA



and professional personnel from the home country (Globerman, 1999).[2] This would encourage a temporary flow of migrants in both directions.

What accounts for the asymmetry in the movement of temporary migrants between Canada and the United States? It may well be that the NAFTA has opened up additional avenues for skilled Canadians working in the US who might not have been able to gain access before. In other words, if there was a pent up demand for Canadians who wished to work in the US but who were prevented from doing so under regular immigration rules, the NAFTA has accorded them at least temporary entry to the American labour market. If this is the case, the question then is why there has been such little movement of temporary workers despite the dramatic increase in the value of trade and foreign investment. An answer to this question rests with the behaviour of multinational firms.

Multinational Enterprises and Temporary Migration

The current economic approach to understanding the behaviour of multinational firms has been named the "knowledge-capital" model by Markusen (2002). He notes that firms that have become multinational enterprises tend to have large stocks of "knowledge" capital related to research and development, marketing, selling new and complex products, and product differentiation. Foreign firms may normally face significant cost disadvantages relative to domestic firms. In the knowledge capital model, knowledge-based assets provide the firms with offsetting advantages to building operations in a foreign country. Markusen divides the advantages into three categories:

> *Ownership advantages*. Knowledge capital may be transferred easily across national borders. International reputations or trademarks may then provide the MNE with a market power advantage over domestic firms. Alternatively, the firm may have a proprietary production technique that provides it with an advantage over domestic firms.
>
> *Location advantages*. The nature of location advantages depends on whether the MNE is horizontal (plants are built in foreign countries to serve the local market) or vertical (production is fragmented into

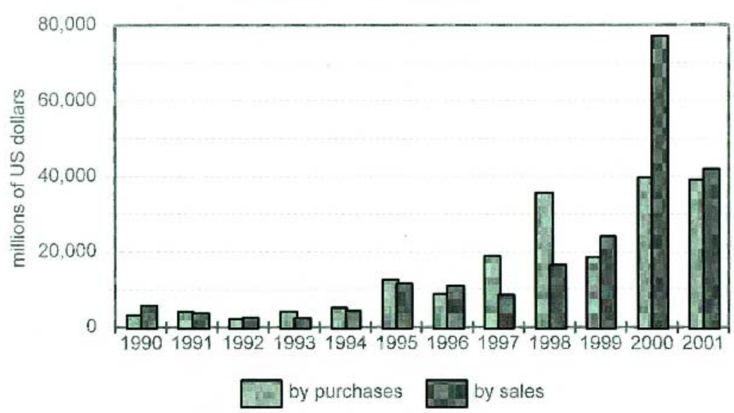
> stages which are located in several different countries). A horizontal structure may arise when there are large trade costs and the size of the foreign market is large. A vertical structure may arise if trade costs are low and there are factor price differences across countries that the firm can exploit. For example, the plant may locate labour intensive parts of the production process in Less-Developed Countries (LDCs) where wages tend to be low. For both the vertical and horizontal structure, headquarter services, research and development, and other skill-intensive services may be concentrated in the home country, provided that knowledge can be transferred across national borders inexpensively.
>
> *Internalization advantages.* In principle, both ownership and location advantages could be realized without the firm directly entering foreign markets. A number of licensing or contracting arrangements would allow the firm to earn a return on its knowledge capital in a foreign market. For example, trademarks could be leased to foreign firms or location advantages could be realized by contracting production with a domestic firm. Therefore, additional reasons must exist for the firm to choose to enter directly into foreign markets and keep all activities internal to the firm. For example, the firm may wish to protect its international reputation. Alternatively, the firm may wish to prevent licensees from absorbing proprietary knowledge and then defecting.

The nature of the multinational enterprise has three important implications for our present consideration of temporary migration. First, given the tendency for the a multinational enterprise to retain the important head office functions (senior management, research and development, and other skills-intensive services) in the home country, establishment of a foreign affiliate does not entail a large demand for skilled workers in the host country.

Second, foreign direct investment may take place through either the building of new facilities or acquisition of an existing firm within the foreign market. Foreign direct investment is often confused with the transfer of real capital goods which may have an accompanying flow of temporary workers. If, however, the foreign direct investment is associated with the purchase of existing assets, then the host country may receive no inflow of physical and human capital. Canada's recent experience with the inflow of US foreign direct investment under the NAFTA has been dominated by acquisitions rather than the establishment of new production facilities. In 2001, for instance, when the flow of US foreign direct investment into Canada totalled $38.7 billion, US firms acquired over $15 billion in the assets of Canadian-owned crude oil producers alone (see Figure 8). While there may be the need to transfer staff on a short-term basis to rationalize production in the newly-purchased affiliate, the inflow would be less than normally required to establish a new enterprise.

Third, whether establishing a new enterprise or acquiring an existing one, the MNE must decide how to staff its foreign affiliate. Employees may be either host country nationals or expatriates. This decision is especially relevant to choosing managers for the foreign affiliate. Head (2003) compares the relative merits of selecting expatriates versus locals for senior management positions. He notes that expatriates are typically reassigned from the company's headquarters, so they are familiar with the multinational enterprise and its operations and are

Figure 8: Foreign Acquisitions
of Canadian Firms, 1990-2001



likely to be known and trusted by management at headquarters. In may also be difficult to find talented managers in a foreign market, where managers may be in short supply. In contrast, local managers are more likely to understand the local market and have better business and political connections. Using locals in senior management may also help hiring, as the company has a visible upward career track.

Locals may have additional advantages over expatriates. Expatriate appointments are expensive, as additional training is required and wage compensation may be necessary. In addition, expatriates are often unable to adjust to a new country, which requires investment on the part of the firm to provide a replacement. In practice, multinational enterprises often use expatriates when starting up. The expatriate manager is provided with a local "apprentice" who eventually takes over once familiarity with the company is obtained (Head, in press). For these reasons, it is not surprising that there has been no significant increase in the demand for temporary migration to Canada since the implementation of the NAFTA. If the above argument holds true, then the increase in Canadians gaining temporary residence status in the US may simply reflect individuals taking advantage of an alternative avenue to permanent migration.

Conclusion

Since greater trade liberalization between Canada and the United States was undertaken in 1989, permanent migration between the two countries remains at relatively low levels by historical standards. Since there is no evidence that the economic incentives for Canadians to move to the US have declined, it is likely that more restrictive US immigration laws are largely responsible for the reduction in permanent migration.

The implementation of the FTA in 1989 has been accompanied by a dramatic increase in trade and capital flows between Canada and the US. In contrast, changes in the flow of temporary migrants have been one-sided, with little change in the inflow to Canada and a sizeable increase in the flows to the US. This asymmetry is attributed to two factors. On the one hand, the NAFTA provisions that facilitate temporary migration have provided an outlet for the "pent up" demand among Canadian skilled workers to emigrate. In contrast, the lack of temporary migration to Canada reflects the nature of multinational enterprises. Their need to staff foreign affiliates with senior management and highly-skilled workers is limited given the tendency to locate key functions in the home economy and to the degree that expansion occurs through acquisition of existing enterprises. Moreover, to the extent that highly-skilled workers are required in the host economy, there is a preference for hiring locally rather than employing expatriates.

This would suggest, therefore, that the limited accommodation to the movement of labour in the NAFTA has not imposed a significant constraint upon trade and investment flows between Canada and the US.

Appendix I: Dales' "Displacement Thesis" Model

A formal model of the "displacement thesis" was offered by Dales to provide a stylised account of Canada's immigration and emigration experience in the immediate post-World War II period.

Consider a world with high, but imperfect, mobility of factors of production. Factor-price equalization does not occur because of different national endowments of natural resources, and different political and social institutions. Competitive market conditions prevail, and full employment is maintained in each country.

There are three regions, Canada, the United States and the rest of the world (ROW). The US has no tariff duties, enjoys a comparative advantage in manufacturing, and has an open immigration policy. Canada imposes a tariff on manufactured goods and has an open immigration policy. The nominal wage in Canada and the US is equal, and above that in ROW ($W_C = W_{US} > W_R$). Because of tariff protection, prices are higher and real wages are lower in Canada than the US such that $w_R < w_C < w_{US}$.

Both Canada and the US restrict immigration from ROW except when there is an excess demand for labour at the prevailing nominal wage W*. There is a perfectly elastic supply of migrants from the ROW at W* such that the nominal wage in Canada and the US never rises above this level. Tariff protection in Canada lowers the real wage, but not enough to trigger a wide-scale emigration to the US because of a positive cost of moving. Given differences in the psychic costs of moving, some Canadians will emigrate while others will not.

The result is that whenever there is excess demand for labour in Canada, there will be an inflow of migrants from the ROW; and whenever there is an excess demand for labour in the US, there is an inflow of migrants from both Canada and the ROW. In general, therefore, when the North American economy is expanding, Canada experiences a simultaneous inflow of labour from the ROW and an outflow to the US. The combination of protectionism and open an immigration policy results in a real wage gap between Canada and the United States. In effect, an open immigration policy suppresses the real wage in Canada and encourages more mobile Canadians to emigrate.

This leads Dales to draw the following observation:

This "population turnover" mechanism leads to some paradoxical conclusions. Protective tariffs, which in popular mythology are supposed to protect native labour from the competition of cheap foreign labour, may end up bringing the cheap foreign labour to the protected country. In the process, of course, the immigrants' standard of living is raised. Protectionism in a rich country acts as a sort of international aid program, and becomes a means of transferring real income from the non-emigrant in the rich country to immigrants in the poor country. (Dales, 1964: 44)

Notes

1. Cassidy and Pearson (2001), in an effort to reconcile immigration data with Census data, estimate that the number of Canadian temporary residents in the US increased from 23,350 to 58,465 between 1990 and 2000. These numbers, as the authors note, are likely a significant understatement of the increase since they do not take into account changes under the NAFTA in their estimates.
2. The reverse causality may also apply: migration may encourage trade by improving information flows between the source and receiving country as the immigrant is able to identify specific market niches in either or both countries. Head and Ries (1998) examined Canada's trade with 136 countries between 1980 and 1992 and found that trade between countries did increase with immigration flows; however, there was a marked imbalance between exports and imports. The estimated annual increase in imports per immigrant ($8,000) was far greater than in exports ($3,000); in other words, immigrants display a strong preference for commodities from their home country while having a small impact on Canadian exports.

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